

SMSFs and loss of capacity

Introduction — the problem

There is an ‘elephant in the SMSF room’. That ‘elephant’ is the issue of what will happen to SMSFs when members lose capacity.

The most recent ATO statistics show that of the 867,863 SMSF members:

- 56% are over 54 years old; and
- 22% are over 64 years old.

Further, the statistics also show that the average value of total assets in an SMSF is \$888,433. (However, because many SMSFs report using historical cost and not market value, the true figure is likely to be higher.)

In other words, there are a significant number of people who will soon enter an age where they might start losing their mental faculties yet control significant wealth in their SMSFs.

At this stage we stress the ‘new-ness’ of SMSFs. Most SMSFs that exist today did not exist 10 years ago.

Accordingly, few practitioners have had much experience in dealing with what will happen with SMSFs when members lose capacity.

However, planning for incapacity is just as important as planning for death.

The 11 steps — the solution

DBA Lawyers believes that there are 11 key steps. These steps can be applied to all SMSFs.

Once applied, the 11 steps result in having planned for all aspects of loss of capacity and death in SMSFs.

These aspects include items such tax efficiency, whether documents like binding death benefit nominations are needed and much more. Of the 11 steps, five are relevant for planning for SMSFs upon loss of capacity (the other six are relevant for planning for death).

This newsletter will briefly describe the five ‘loss of capacity’ steps.

Step 1 — identify the governing rules

The governing rules are typically found in the most recent deed of the fund. A trustee’s first duty is to follow these rules and these rules can override

many general law duties and obligations. The governing rules will answer questions such as:

- Who can remove an incapacitated trustee and appoint a replacement?
- When does a person cease to be a trustee (eg, upon loss of capacity)?
- Can a trustee nominate an automatic successor trustee such as their legal personal representative?

Essentially, the governing rules form the foundation upon which all the other steps build.

Step 2 — strongly consider a sole purpose corporate trustee

There are many advantages of a sole purpose corporate trustee of an SMSF. One advantage is administrative efficiency upon loss of capacity or death.

For example, when a trustee loses capacity, typically a change of trustee is required. Hence, the name in which all SMSF assets are held must be changed. This will involve contacting share registries, land title offices, banks and more. It can be very time consuming and frustrating.

However, if there is a sole purpose corporate trustee, all that is needed is change of director paperwork and to alert the ATO and ASIC.

Step 3 — ensure shareholding in trustee distributes voting power appropriately

Under many constitutions, shareholders have the power to appoint and remove directors.

Accordingly, it is vital that the shares — and hence this power — are appropriately distributed.

One rule of thumb that is applicable for the bulk of SMSF clients is that:

- each member personally owns half the shares; and
- if either of the members have children from a previous relationship — each member should nominate the executors of their will as ‘successor directors’.

Step 4 — ensure enduring powers of attorney in place for each member

Enduring powers of attorney are absolutely vital.

Being a member of an SMSF yet not having an enduring power of attorney is tantamount to planning for disaster.

Consider the following.

Case study

William and Wynona are the only trustees and members of an SMSF. They do not have enduring powers of attorney. William becomes senile and loses capacity.

Unless the governing rules provide otherwise, William is still a trustee of the SMSF. Further, unless the SMSF's specific governing rules provide otherwise, there is an equitable principle that all trustees must agree upon all trustee decisions. If William is incapable of decision making, Wynona can't proceed without him.

Accordingly, in order to be able to run the SMSF, William must be removed.

Assume that under the governing rules Wynona is able to arrange for William to be removed as a trustee. This will leave Wynona as the sole trustee and William and Wynona as the members. However, in order to be an SMSF, typically all members must be trustees. Accordingly, this structure will eventually force the fund to cease to be an SMSF (and thus potentially become non-complying).

A relevant exception applies if Wynona held an enduring power of attorney in respect of William. If

this were the case, she could be the sole trustee and the fund could continue with this structure indefinitely.

Step 5 — identify who will be running the SMSF upon member's loss of capacity

Once the prior four steps have been determined, by reading the governing rules, it is possible to determine who will be running the SMSF upon the member's loss of capacity. Naturally, if the member is unhappy with the outcome, steps 1–4 can be tweaked so that the member is happy. For example, it might be revealed that a second spouse will be solely running the SMSF. However, the member might want the second spouse in conjunction with children from a prior relationship to run the SMSF.

Further information

DBA Lawyers publishes a 140+ page book: *The Complete Guide to SMSFs and Planning for Loss of Capacity and Death*. The book details all the 11 steps and contains 90+ examples, detailed case studies and much more. The book can be ordered below. For more information (including a detailed table of contents), please visit www.dbalawyers.com.au/complete-guide

This unique book provides a practical and detailed road map for advisers to tremendously assist all SMSF clients and answer some of the most tricky questions authoritatively.

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